Moody's Investors Service

Global Credit Research
Rating Update
5 OCT 2001

Rating Update: **California (State of)**

MOODY'S PLACES STATE OF CALIFORNIA'S Aa3 GENERAL OBLIGATION BOND RATING ON WATCHLIST FOR POSSIBLE DOWNGRADE

State
CA

Opinion

NEW YORK, Oct 5, 2001 -- Moody's has placed the State of California's general obligation bond rating under review for possible downgrade. This action is prompted by increased concerns regarding the state's economically sensitive General Fund revenues in the aftermath of the September 11th terrorist attacks and other recent developments that threaten the timely issuance of power revenue bonds. Proceeds of such bonds are needed to shore-up the state's now more precarious projected liquidity position.

Moody's intends to closely monitor and review developments in these two areas over the near term and will either affirm or downgrade the state's rating. Our review will also encompass the ratings on the state's various lease revenue bond programs, as well as the fiscal 2002 Revenue Anticipation Notes. Accordingly, total debt affected is approximately $31.6 billion.

HEIGHTENED CONCERNS REGARDING ECONOMICALLY-SENSITIVE REVENUES

The state's financial position is heavily dependent on economically-sensitive revenues, and the more negative national economic outlook that has emerged since September 11th is likely to produce revenue under-performance beyond the margins provided for in the enacted budget. Broad measures of economic activity are likely to be weaker than earlier forecasts predicted and

stock option and capital gains-related tax collections are a key source of vulnerability. In the current fiscal year, the enacted state budget anticipates these stock market-related tax revenues will total $12.5 billion, approximately 16% of total General Fund revenues. The state reduced its stock option and capital gains revenue estimate from prior year totals by more than $5 billion -- based on its market forecast, analysis of trading volumes, holding periods, and the estimated inventory of unexercised options at large technology firms in the state. Although moderately cautious at the time the budget was enacted, this forecast now appears risky.

The forecast assumed that market indexes would be considerably higher than today's levels. And certain estimates of the total stock of unrealized capital gains in the US equity market have been significantly revised downward since the budget was passed in early July, to levels last seen in 1998. The magnitude of the effect on state revenues is far from clear, as is the likely course of the market over the balance of the fiscal year. However, Moody's has new concerns the state's budgeted $2.6 billion reserve could be insufficient to offset the under-performance in stock market-related tax collections if the major indices do not improve significantly from current levels. Should revenue collections fall below estimates and outstrip the budget reserve, the state would be forced to seek legislative authorization to implement significant spending limitations. Based on its limited financial flexibility (due mainly to education expenditures mandated by Proposition 98), the state would likely find it difficult to adopt sufficient budgetary reductions to address any significant revenue shortfall, especially since such a large proportion of economically sensitive revenues is received in the second half of the fiscal year.

NEW RISKS EMERGE TO TIMELY ISSUANCE OF POWER REVENUE BONDS

The state's current year budget assumes that prior to June 30,2002, the State Department of Water Resources (DWR) power bond sale will be finalized and the General Fund will be fully repaid the $6.2 billion it is owed for past power purchase advances. However, recent actions taken by both the State Legislature and the California Public Utility Commission (CPUC) concerning the rate agreement between DWR and the

CPUC increase the risk the state will be unable to issue these bonds prior to the end of the current fiscal year.

These actions include: the CPUC's rejection of the rate agreement as currently proposed by the DWR; and the legislature's adoption of Senate Bill 18XX which would lead to protracted litigation over existing DWR power purchase contracts. The Governor is expected to veto SB 18XX, but it is not known at this time whether the legislature will act to override his anticipated action. Similarly, should the veto of Senate Bill 18XX hold, the CPUC's intentions are very unclear given its reluctance to allow the power purchase bond program as authorized in AB 1X to proceed.

These actions include: the CPUC's rejection of the rate agreement as currently proposed by the DWR; and the legislature's adoption of Senate BillX2 18 which would lead to protracted litigation over existing DWR power purchase contracts. The SBX2 18 legislation that is waiting the Governor's signature would establish a bond set-aside payment that would have first priority of payment claim. This change would likely lead to impairment of contract litigation by the power generators. The Governor is expected to veto SBX2 18. It is not known at this time whether the legislature will act to override his anticipated action. Should the veto of Senate BillX2 18 hold, the CPUC's intentions are unclear given its reluctance to support the DWR rate agreement for the power purchase bond program as authorized in AB 1X.

If the economy were stronger, the state would have more time to consider alternative approaches to the DWR power bond program authorized under AB1X. However, given current tax revenue risks, General Fund liquidity depends heavily on receiving expected power bond proceeds no later than the last quarter of the fiscal year. Absent those proceeds, it is likely that the state will need an alternate source of liquidity, similar to the Revenue Anticipation Warrants issued in the early 1990's.

The state has not as yet determined what actions, if any, it will take to address the CPUC's objections to the revenue agreement.

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